DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 99-0293
Corporate Income Tax
For Years 1993 - 1995

NOTICE: Under Ind. Code § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Income Tax – Sales Factor Denominator

Authority: Ind. Code § 6-8.1-5-1.

The taxpayer protests the calculation of the sales factor denominator.

II. Income Tax – Foreign Source Dividends

Authority: Ind. Code § 6-3-2-12;
Kraft General Foods, Inc. v. Iowa Dept. of Revenue, 112 S. Ct. 2365 (1992).

The taxpayer protests the reduction of the foreign source dividend deduction by related expenses.

III. Income Tax – Interest and Royalties as Business Income

Authority: Ind. Code § 6-8.1-5-1;
Ind. Admin. Code tit. 45, r. 3.1-1-59;
Ind. Admin. Code tit. 45, r. 3.1-1-61.

The taxpayer protests the treatment of interest and royalty income as business income.

STATEMENT OF FACTS

The taxpayer is a Delaware corporation doing business in the state of Indiana. The taxpayer is a manufacturer of paper machine clothing, which is a fabric material used in the manufacture of paper. The paper machine clothing conveys the developing paper web through various production steps in a papermaking machine. A corporate income tax audit was completed on November 24, 1997. The taxpayer filed a protest and a telephone conference was held on April 27, 2000. The taxpayer was given additional time to submit evidence concerning foreign dividend income expense and, on June 16, 2000, did submit such evidence.

I. Income Tax – Sales Factor Denominator

DISCUSSION

The taxpayer protests the calculation of the sales factor denominator. "The notice of proposed assessment is *prima facie* evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Ind. Code § 6-8.1-5-1(b). The taxpayer has met its burden of proof on this issue. The Department has determined that the Audit Division miscalculated the sales factor denominator for the audit period. For purposes of calculating the sales factor, sales in the numerator and denominator are to be reported at net of returns and allowances, rather than at gross. However, to allow for a consistent calculation of both the numerator and denominator for this taxpayer, the denominator will be adjusted to gross sales.

FINDING

The taxpayer's protest is sustained.

II. Income Tax – Foreign Source Dividends

DISCUSSION

The taxpayer protests the reduction of its foreign source dividend income deduction by 15% for related expenses. The taxpayer's position is that U.S. source dividend deductions are not subject to the 15% reduction for related expenses while foreign source dividends are. The taxpayer maintains this discriminates against foreign commerce in violation of the U.S. Constitution. The taxpayer has cited the case of Kraft General Foods Inc. v. Iowa Dept. of Revenue, 112 S. Ct. 2365 (1992), to support its argument.

As is provided by Indiana law, the taxpayer was given a 100% deduction for foreign source dividend income from corporations the taxpayer had an 80% or larger ownership interest in; an 85% deduction for dividends from corporations the taxpayer owned a 50-80% interest in; and a 50% deduction for dividends from corporations the taxpayer owned less than a 50% interest in. Ind. Code § 6-3-2-12(b-e).

The instant case is distinguishable from the Kraft case. In Kraft, the Supreme Court found that an Iowa law that taxed foreign source dividends of corporations, but not domestic source dividends, discriminated against foreign commerce in violation of the Commerce Clause of the U.S. Constitution. The Indiana statute, in contrast to the Iowa law, does permit the deduction of foreign source dividend income.

The presumption that 15% of dividend income represents related expenses is rebuttable upon presentation by the taxpayer of acceptable proof that a lesser amount is attributable to such expenses. The taxpayer has submitted sufficient evidence to rebut the Department's finding that 15% of the taxpayer's foreign dividend income is attributable to direct expenses.

FINDING

The taxpayer's protest is sustained.

III. Income Tax – Interest and Royalties as Business Income

DISCUSSION

The taxpayer stated in its protest letter that it did "not entirely agree with the agent's position on the issue of non-business income." Taxpayer's Protest Letter, p. 2 (Feb. 9, 1998). During the telephone conference, the taxpayer indicated that what it disagreed with was the auditor's assessment of tax on interest income and income from rents and royalties. The taxpayer offers no further argument or evidence.

According to the audit report, the interest income received by the taxpayer came from loans the taxpayer had made to its foreign subsidiaries. The taxpayer had deducted the interest income on its tax returns as non-business income. The auditor disallowed the deduction, stating that the interest was apportionable business income.

> Interest income is non-business income if the intangible with respect to which the interest was received did not arise out of or was not created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible was not related to or incidental to such trade or business operations.

Ind. Admin. Code tit. 45, r. 3.1-1-59.

The auditor determined that the interest income was created in the regular course of the taxpayer's trade or business and was, therefore, apportionable business income, rather than allocable non-business income.

Similarly, the auditor found that the taxpayer's royalty income was non-deductible business income. The royalty income is from the licensing of technology by the taxpayer to its foreign subsidiaries.

> Patent and copyright royalties are non-business income if the patent or copyright with respect to which the royalties were received did not arise out of or was not created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the patent or copyright is not related to or incidental to such trade or business operations.

Ind. Admin. Code tit. 45, r. 3.1-1-61.

The auditor determined that the royalty income was directly related to the taxpayer's trade or business and was, therefore, apportionable business income, rather than allocable non-business income.

The taxpayer has the burden of proving that the tax assessment is wrong. Ind. Code § 6-8.1-5-1(b). The taxpayer has offered no evidence to show that the interest and royalty income should be classified as deductible non-business income. The auditor correctly treated the interest and royalty income as taxable business income.

FINDING

The taxpayer's protest is denied.

RLH/BRK/MR-002710